Erlanger Squeeze Play

Indicator Focus: Squeezeometer

by Phil Erlanger

A core function of our research centers on the concept of advance phases and decline phases. Whether we're in a bull or bear market, there is a constant swing from excesses of bullish sentiment to excesses of bearish sentiment. The market seems to wait for an excess to appear before shifting direction. Hence, each "phase" is a squeeze play.

We have observed that these phases occur on a short-term, intermediate-term, and long-term basis. We judge each term by looking at hourly, daily and weekly data, respectively.

Our "Squeezeometer" table is designed to indicate which phase (advance or decline) is underway for each of the three terms. Moreover, each phase has four sections to indicate a turn into the direction of the phase, the early establishment of trend, the sweet spot of the trend, and the maturing of trend.

Since there are four sections to each of two phases, there are eight rows in our Squeezeometer table.

SQUEEZEOMETER 11/02/01

Closing Data

	LT	INT	ST	
Turning Up				Speculative Buy
Early Uptrend				Buy
Uptrend		46	35	Hold
Mature Uptrend				Set tight stops/sell
Turning Down				Speculative short or cash
Early Downtrend				Short or cash
Downtrend				Hold shorts or cash
Mature Downtrend	41			Set tight stops/cover or cash
	WEEKLY	DAILY	HOURLY	

Note that only one "cell" in each column is active. An active cell is identified by colors and numbers. Mature uptrends and mature downtrends are always colored as yellow, because conservative tactics are usually appropriate at such times. Other cells are colored green or red where appropriate.

The numbers you see in some cells (the active ones) represent our buy or sell confidence index (see explanation below). We actually have three sets of "Buy" and "Sell" indices -- a set for each of long, intermediate and short terms.

Decline phase cells are bordered in red, advance phase cells are bordered in green.

As our various indicators highlight the market's price action, the various cells become active, indicating the posture of the market. The confidence index numbers indicate the squeeze potential during each of the four stages. In the four "advance" phase stages, the confidence numbers are derived from the "buy confidence index" for that column's periodicity (weekly, daily or hourly). In the four "decline" phase stages, the confidence numbers are derived from the "sell confidence index". As a phase begins, the typical behavior is for confidence to be high (up to a maximum of 100). As the phase progresses, and the cells indicate the later stages, it is reasonable to expect the confidence index (a measure of sentiment) to decrease.

Currently, the LT column is active (filled by the color yellow) on the cell marked "mature downtrend". The number "41" tells us that the Sell Confidence Index based on weekly data is on the low side. This number can actually get to zero if the VIX rises enough. Remember, the more negative the sentiment, the less confidence we have in being bearish ourselves.

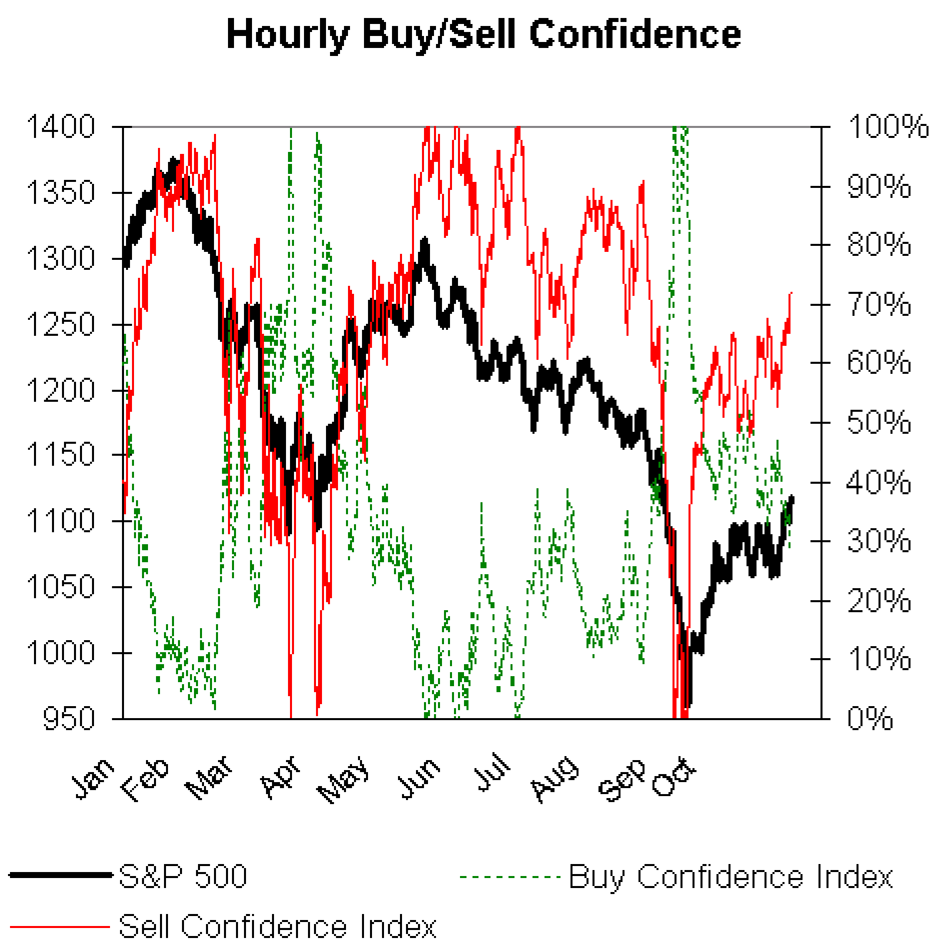
We are in an uptrend stage for both the intermediate and short term columns. The numbers in those green cells reflect the daily and hourly buy confidence indices. They are on the low side, indicating the stronger market is becoming recognized. If the VIX falls to the mid to low 20s, these confidence indices will shrink further (zero is the lowest they can go).

It's often easy to get caught up in short-term moves. The Squeezeometer is designed to track the hourly shifts in the market, but it is also designed to force us to remain aware of the bigger picture represented by the daily and weekly statistics. In our experience, the bigger picture is of greater value than the shorter-term fluctuations.

Indicator Focus: Buy/Sell Confidence Index

Options trading is a great measure of sentiment. One indicator we have used is the CBOE Volatility Index (VIX). The VIX measures the willingness of traders to overpay for OEX put options relative to call options. Therefore, the higher the VIX, the more bearish the prevailing sentiment is.

Adding to our arsenal, we have crafted a tool called the Buy/Sell Confidence Index, which is an important part of our "Squeezeometer". When the Buy Confidence Index is high, sentiment as expressed by the VIX is excessively bearish. When the Sell Confidence Index is high, sentiment as expressed by the VIX is excessively bullish. The Buy/Sell Confidence Index can be calculated on an hourly, daily or weekly basis. In order to see how this indicator may be used as a decision making tool, we will examine the hourly Buy/Sell Confidence Index.



The Buy/Sell Confidence Index should be used as a way to set up a contrary trade/investment. The key is "contrary to what?" We don't ordinarily want to trade contrary to the intermediate or long-term trend, which in the current situation is down. More money has been lost by traders who have built positions thinking a new trend is about to unfold, only to have their hopes, along with their capital, dashed as the primary trend resumes. In the recent environment, we certainly saw bearishness peak with the 100% reading of the Buy Confidence Index. We think it safe to say that even without the attack on the World Trade Center, the long and intermediate market trend is down.

Our tactic has been one of pruning our short portfolio following the first reading of 100% on the Buy Confidence Index, which occurred at 10:30am 09/17/01, the first hour of trading after the attack and when the S&P500 sank from 1092.40 prior to the attack to 1043.78. Notice that the Buy Confidence Index has spent many hours at 100% for the rest of that historic first week of post-attack trading. As our model portfolio numbers below show, we issued Portfolio Alerts adjusting the portfolio by pruning down our list of issues short to a select few.

In the example chart, the hourly Buy Confidence Index is down to 43%, in sync with the rally that occurred the prior week. If it goes to 0% (which would mean the Sell Confidence Index would be at 100%), we would add back some short positions.

A comment: a glance at the Buy/Sell Confidence Index chart above might cause the observer to think that we should have been going long with the 100% reading of the Buy Confidence Index. After all, look at the short-term jump in some stock prices that occurred. Our goal as traders and investors is, however, to put the odds of success in our favor. We hate to lose capital. In our experience trading against the long-term trend is a losing proposition. This year is a classic example of traders and investors who thought at every minor rally the recovery was at hand. We note, with just a bit of outrage, the plethora of high profile analysts who have used the attack on the WTC to change their outlook. Even Alice Rivlin, former Fed Vice Chairman, is using the attack as the reason this year's 8 rate cuts have failed to stimulate the economy. Our point is that the best entry points are setup by sentiment extremes contrary to the longer, primary trends. I

In the current situation, the latter tactic dictates waiting for the next 100% (or near 100%) reading of the Sell Confidence Index to re-establish short positions. This is further supported because October and early November constitute a weak seasonal period when the market is will suffer the added stress of third quarter earnings (or lack thereof) reports.

Interestingly, the Buy/Sell Confidence Index is a great way to confirm the primary trend. By again looking at the Buy/Sell Confidence Index above, you will note that the indices shift from one extreme to another, back and forth. This is an endless cycle. What changes is how the market behaves during each cycle phase, and how persistent each phase is!

In the above chart, we see a complete cycle, highlighted by two peaks in each index. While the two peaks in the Buy Confidence Index (the green, dashed line) illustrate short-term lows, the second was dramatically lower than the first. We have pointed to this lower low in the chart. Moreover, from the first Sell Confidence Index peak to the second, the market declined to a lower high. We have also pointed this out in the chart. A big clue to a "primary" trend change is the observation of higher highs and higher lows. When we see this trend change we will get more aggressive with taking long positions.